

**Many Taxpayers Are Paying Self-Employment  
Tax for Which They Receive No Social  
Security Credit**

**May 2003**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

May 12, 2003

MEMORANDUM FOR ACTING COMMISSIONER, SMALL BUSINESS/  
SELF-EMPLOYED DIVISION

*Gordon C. Milbourn III*

FROM: Gordon C. Milbourn III  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Many Taxpayers Are Paying  
Self-Employment Tax for Which They Receive No Social  
Security Credit (Audit # 200130050)

This report presents the results of our review of the Internal Revenue Service's (IRS) self-employment (SE) tax program. The overall objective of this review was to evaluate the inequities in the SE tax program.

We identified two areas where the IRS has an opportunity to address inequities found in the SE tax program. First, we estimate that taxpayers are paying almost \$24 million and spending over 224,000 hours in fulfilling their SE tax filing responsibilities without receiving any credit with the Social Security Administration (SSA). The SSA requires at least \$780 of net income be earned before a credit is granted, while current tax law requires SE tax to be paid on net income of \$400 or more. Taxpayers who filed the Self-Employment Tax (Schedule SE) on net self-employment earnings of less than \$780 in Tax Year (TY) 2000 without having any Social Security wage income did not earn any credit towards their retirement on their individual accounts with the SSA. We have estimated that over 258,000 taxpayers were affected by this inequity in TY 2000.

In addition, taxpayers who pay only the Medicare portion of the SE tax bear a significant time burden when compared to other taxpayers who are paying the full SE tax. The taxpayers paying only the Medicare portion are required to file a long Schedule SE.<sup>1</sup> An estimated 243,000 taxpayers have spent an additional 190,000 hours in the various activities involved with filing a long Schedule SE, as compared to a short Schedule SE, to report SE income of at least \$780. The annual dollar value of these taxpayers' time spent unnecessarily is an estimated \$5 million.

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<sup>1</sup> Schedule SE has two distinct sections. Section A is a short Schedule SE, and Section B is a long Schedule SE.

We recommended that the IRS evaluate the Internal Revenue Code provisions relating to the SE tax and its filing requirements, and design a possible legislative solution to address the inequity. In addition, the IRS should evaluate the design and clarity of the Schedule SE and its instructions in order to alleviate the excess taxpayer burden.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, agreed that a change to the tax law will address the statutory inequity discussed in the report. SB/SE Division management agreed to re-evaluate the issue and submit a proposal to the National Taxpayer Advocate for possible inclusion in its 2004 Annual Report to Congress if the SSA would co-sponsor statutory resolution. They have also implemented corrective actions to address the clarity and design of the Schedule SE. They will be circulating revised instructions soon that will reduce taxpayers' reporting burden.

Management's complete response to the draft report is included as Appendix VI. In addition, the National Taxpayer Advocate's comments on the draft report are included as Appendix VII.

Copies of this report are also being sent to IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

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## Many Taxpayers Are Paying Self-Employment Tax for Which They Receive No Social Security Credit

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### Background

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Self-employed taxpayers have to pay Social Security and Medicare taxes, which are called self-employment (SE) taxes, when their net earnings from SE are at least \$400 for the tax year. Since 1951, self-employed taxpayers have been covered by Social Security, and they can receive Social Security credit for their earnings.

Self-employed taxpayers figure the SE tax by filing the Self-Employment Tax (Schedule SE) with their individual tax returns. The SE tax rate is 15.3 percent of net earnings and consists of two parts: 12.4 percent for Social Security and 2.9 percent for Medicare. The Social Security tax portion has a maximum contribution base that is determined under provisions of the Social Security Act.<sup>1</sup> In 2000, the contribution base was \$76,200. Self-employed taxpayers can deduct one-half of their SE tax from their gross income.<sup>2</sup>

During individuals' working years, their wages are posted to their Social Security records, and they receive earnings credits based on those wages. The amount of earnings required for a credit by Social Security in 2000 was \$780. Individuals can earn up to four credits, also known as quarters of coverage, per year. Since 1978, the amount of earnings needed for a quarter of coverage increases automatically each year with increases in the national average wage index. Everyone born in 1929 or later needs 40 credits to be eligible for retirement benefits. See Appendix V for an overview of the Social Security program and its various requirements.

We performed this audit at the Brookhaven Internal Revenue Service (IRS) Campus between October 2001 and September 2002. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>1</sup> 42 U.S.C. § 430 (b) (1994).

<sup>2</sup> 26 U.S.C. § 164 (f) (1) (1996).

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### **Thousands of Taxpayers Pay Self-Employment Tax but Receive No Social Security Credit**

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Section 1401 of the current tax code<sup>3</sup> imposes a tax on an individual's SE income. Section 1402 of the same tax code defines SE income as "net earnings from self-employment." Self-employed taxpayers are required to file a Schedule SE when their net earnings from SE are at least \$400.<sup>4</sup>

However, the Social Security Administration (SSA) does not grant credit for amounts earned below a specific amount (threshold amount). The amount of earnings needed for a credit rises as the average earnings level rises nationally. The table in Appendix V shows the threshold amount and the applicable SE tax for the years in question. In Tax Year (TY) 2000, for example, the minimum net earnings necessary to receive a credit was \$780, which would result in the payment of \$119.34 (\$780 times 15.3 percent) in SE tax.

For TY 2000, an estimated 258,000 taxpayers paid an estimated \$23.6 million in SE tax to the IRS for which they received no credit towards their retirement on their individual accounts with the SSA. These taxpayers did not receive credit because their net earnings from SE were greater than \$400 but less than the threshold of \$780, and they had no other creditable Social Security wages. In addition, these taxpayers spent over 224,000 hours in fulfilling their SE tax filing responsibilities, again without receiving a benefit.

To arrive at this estimate, we identified, through a computer extract, 1.1 million individual tax returns for TY 2000 where the taxpayer had indicated a SE tax liability of less than \$119.34. These 1.1 million returns had generated over \$90 million in revenue for the Social Security and Medicare trust funds. We limited our analysis to these returns because the amount of SE tax paid was less than what would be required if the filing requirement under the Internal Revenue Code (I.R.C.) was equivalent to the threshold amount set by the SSA.

The taxpayers that would be most adversely affected are those who had no other creditable SSA income for the tax

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<sup>3</sup> 26 U.S.C. § 1401 (1990).

<sup>4</sup> 26 U.S.C. § 6017 (1954).

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year (no Wage and Tax Statement (W-2) or no Social Security wages). Taxpayers with creditable SSA income could benefit from net earnings below the threshold, as the earnings would be added to their wage base for future benefit calculations or could result in additional quarters of credit. See Appendix V for more detail. In addition, some taxpayers may be liable for only the Medicare portion of the SE tax (2.9 percent) if they have received Social Security wages in excess of the contribution base (\$76,200).

We selected a statistically valid sample of 1,460 taxpayers from the 1.1 million identified and reviewed their TY 2000 tax returns. We determined that:

- 398 (27 percent) of the SE tax liabilities were only for the Medicare portion.
- 340 (23 percent) paid both the Social Security and Medicare portions and would not receive Social Security credit for their income.
- 70 (5 percent) of the taxpayers received additional credits as a result of the SE income reported on their returns.
- 722 (45 percent) of the returns paid both portions and would have their income added to their wage base.

The SE tax was calculated based on a Profit or Loss From Business (Schedule C) in approximately 80 percent of the returns reviewed.

The following table presents a projection of the sample results to the population of 1.1 million taxpayers.

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**Figure 1**  
**Estimated Breakdown of Tax Year 2000**  
**Self-Employment Taxes Paid**

|   | Number of Taxpayers | Percentage |
|---|---------------------|------------|
| Taxpayers paying only Medicare portion  | 303,060             | 27.3%      |
| Taxpayers paying both portions (Medicare and Social Security) who would receive no Social Security credit | 258,896             | 23.3%      |
| Taxpayers paying both portions who would receive credit for additional quarter(s)                         | 53,302              | 4.8%       |
| Taxpayers paying both portions who would receive only an increase in their wage base                      | 496,468             | 44.6%      |
| Totals  | 1,111,726           | 100%       |

*Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the audit sample projected to the universe of returns with SE tax paid below the threshold amount.*

The 258,896 taxpayers who paid both the Social Security and Medicare portions, but who would receive no Social Security credit, have spent time in fulfilling their SE tax obligations. The IRS' computation of the amount of time a taxpayer will spend, on average, for various activities involved with keeping records and filing a short Schedule SE is 52 minutes. Therefore, for TY 2000, these taxpayers spent over 224,000 hours to comply with the current tax law. In addition, 60,155 of the taxpayers paying only the Medicare portion of the SE tax had earnings from SE that were below the SSA threshold. They spent, on average, 99 minutes for a long Schedule SE, resulting in an additional 99,000 hours (60,155 times 99 minutes). In total, approximately 319,000 taxpayers spent over 324,000 hours complying with the law.

The Office of Management and Budget (OMB) reports annually to the Congress on the costs and benefits of federal regulations. In their report for 2000, the OMB used a figure of \$26.50 per hour as the estimate of the average value of

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time for the individuals and entities that provide information to the Federal Government. If we apply this \$26.50 figure to the calculated 324,000 additional hours, the total monetary cost savings to taxpayers would project to almost \$8.6 million dollars per year.

Over the past several years, the IRS has been working with IBM Business Consulting Services (IBM) to develop a more accurate and dynamic methodology for measuring taxpayer burden. The work has been completed and the model delivered for measuring burden on individual taxpayers. The model measures taxpayer compliance burden in terms of both time and out-of-pocket costs incurred by taxpayers with respect to pre-filing and filing activities. The IRS and IBM are now working on improving the methodology for measuring the compliance burden imposed on small business taxpayers, as well.

Based on Figure 1, 32 percent (258,896 out of 808,666) of all taxpayers who paid the full SE tax did not have any other creditable Social Security earnings for the tax year. These taxpayers fulfilled their legal obligation under the current tax law, but some were denied any benefit because the tax law conflicts with the rules, regulations, and requirements of the SSA. In fact, the tax law amount has been lower than the SSA threshold since 1985.

The IRS has an opportunity to address inequities found in the SE tax program. There is no exception to the SE tax provisions of the I.R.C. that would provide those taxpayers relief from their SE tax liabilities. The IRS cannot offer those taxpayers any administrative relief since this is a statutory provision. This specific area of taxpayer burden was highlighted in the recent presentation of the model to measure taxpayer compliance burdens developed for the IRS by IBM. The discrepancy between SSA standards and the filing requirement for self-employed taxpayers had also been cited previously in the National Taxpayer Advocate's Fiscal Year (FY) 2000 Annual Report to Congress.<sup>5</sup>

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<sup>5</sup> National Taxpayer Advocate's FY 2000 Annual Report to Congress, page 94.

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### Recommendation

1. The Commissioner, Small Business/Self-Employed (SB/SE) Division, should coordinate with Chief Counsel; the Director, Legislative Affairs; the National Taxpayer Advocate; and the SSA to evaluate the tax law and design a possible legislative solution to address the inequity and reduce the excess taxpayer burden.

Management's Response: The Commissioner, SB/SE Division, recognized that a change to the tax law will address the statutory inequity discussed. If the SSA will support co-sponsored statutory resolution, the SB/SE Division will re-evaluate the issue using current data and submit a proposal to the National Taxpayer Advocate for possible inclusion in its 2004 Annual Report to Congress.

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### Taxpayers Who Are Liable Only for the Medicare Portion of Self-Employment Tax Are Being Unfairly Burdened

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Almost 243,000 taxpayers are spending an additional 190,000 hours preparing the Schedule SE that can possibly be avoided. As noted before, taxpayers must pay SE tax and file a Schedule SE if they are self-employed and their net earnings from SE are at least \$400 for the tax year. The SE tax rate on net earnings is 15.3 percent, which consists of 12.4 percent for Social Security and 2.9 percent for Medicare. The maximum amount subject to the Social Security part for TY 2000 is \$76,200. All net earnings of at least \$400 are subject to the Medicare tax.

The TY 2000 instructions for the Schedule SE<sup>6</sup> state that taxpayers whose total of Social Security wages and net earnings from SE exceed the Social Security maximum of \$76,200 **must** file a long Schedule SE. Most other taxpayers can use the short Schedule SE to compute their liability.

As shown in the instructions for the U.S. Individual Income Tax Return (Form 1040), the IRS has already estimated the amount of time a taxpayer will spend, on average, for various activities involved with the Schedule SE. Figure 2 shows that the time difference between filing a long versus a short Schedule SE is 47 minutes.

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<sup>6</sup> Schedule SE has two distinct sections. Section A is a short Schedule SE, and Section B is a long Schedule SE.

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**Figure 2**  
**Average Times (Estimated) Associated With**  
**Schedule SE Activities (Tax Year 2000)**

|                                 | <b>Short Method<br/>(in minutes)</b> | <b>Long Method<br/>(in minutes)</b> |
|---------------------------------|--------------------------------------|-------------------------------------|
| Record keeping                  | 13                                   | 26                                  |
| Learning about the law and form | 14                                   | 20                                  |
| Preparation                     | 12                                   | 33                                  |
| Misc. other <sup>7</sup>        | 13                                   | 20                                  |
| Totals                          | 52                                   | 99                                  |

*Source: IRS' 2000 instructions for Form 1040.*

Our initial analysis of the sample of 1,460 taxpayers identified 398 taxpayers who had paid only the Medicare portion of the SE tax because their wage income had exceeded the Social Security maximum. We performed an additional review of these taxpayers' returns to determine how many had paid their Medicare tax on net earnings that did not meet the TY 2000 threshold as established by the SSA. We determined that 79 (20 percent) of the returns showed net earnings from SE that were less than \$780. These taxpayers would no longer have to file a Schedule SE if the Congress enacted a legislative change to address the inequity described earlier in this report and made the filing threshold equal to the threshold set by the SSA.

The remaining 319 taxpayers (80 percent) would still be responsible for filing a Schedule SE. However, their burden would be reduced if they were allowed to file a short rather than a Long Schedule SE. For TY 2000, a short Schedule SE required a taxpayer to make an entry on a maximum of 5 lines, while the Long Schedule SE required 12 entries. However, three of these entries involve the taxpayer's total wages and the maximum Social Security earnings amount, and would always result in no SE tax for these specific taxpayers.

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<sup>7</sup> Includes copying, assembling, and mailing the form.

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The table below shows the projection of our sample results to the population, as well as the total time savings computation.

**Figure 3**  
**Projection of Sample Results to Tax Year 2000 Population and Calculation of Time Saved**

|   |            |       |
|---|------------|-------|
|   |            |       |
| Taxpayers paying only Medicare portion  | 303,060    | 100%  |
| Taxpayers with less than \$780 SE income  | 60,155     | 19.8% |
| Taxpayers with \$780 or more of SE income                                       | 242,905    | 80.2% |
| Time Differential between short and long methods – Schedule SE (minutes)        | 47         |       |
| Total Time Differential for taxpayers with \$780 or more of SE income (minutes) | 11,416,535 |       |
| Total Time Differential (hours)   | 190,276    |       |

*Source: TIGTA analysis of the audit sample projected to the universe of returns with Medicare tax only paid.*

By applying the previously cited OMB \$26.50 per hour figure to the calculated 190,276 additional hours, the total monetary cost savings to taxpayers projects to over \$5 million dollars per year.

One of the 10 major strategies included in the IRS' Strategic Plan is the reduction of taxpayer burden. To help achieve significant burden reduction for SB/SE Division taxpayers, the IRS has created the Office of Taxpayer Burden Reduction (OTBR). In testimony before the House Government Reform Committee in April 2002, the IRS Commissioner spoke about the OTBR and stated:

*“The OBTR will focus its efforts in four major areas: (1) informing and educating customers about their tax responsibilities; (2) simplifying forms, publications, and communications; (3) streamlining internal policies, processes and procedures (including audit plans); and (4) promoting less burdensome rulings, regulations and laws.”*

Implementing corrective actions to our recommendations would enhance this strategy.

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### Recommendation

2. The SB/SE Division's Director, Taxpayer Education and Communication; and Director, Tax Burden Reduction, should coordinate with the Wage and Investment Division's Director, Tax Forms and Publications, to evaluate the design and clarity of the Schedule SE and its instructions in order to alleviate the additional taxpayer burden.

Management's Response: The Tax Forms and Publications function has already evaluated the Schedule SE and will soon circulate revised instructions, which will reduce reporting burden by allowing certain taxpayers to "skip" lines on the Long Schedule SE.

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### **Appendix I**

#### **Detailed Objective, Scope, and Methodology**

The objective of this audit was to evaluate the inequities in the self-employment (SE) tax program.

To accomplish the objective, we analyzed tax return information and interviewed Internal Revenue Service (IRS) personnel. Our audit work was performed at the Brookhaven IRS Campus. However, our analysis included data taken nationwide from tax returns posted to the IRS' Individual Master File.<sup>1</sup> Due to the large volume of tax return information, we selected a sample from nationwide data using statistically valid sampling techniques. Specifically, we performed the following audit tests:

- I. Determined how many taxpayers paid SE tax that would not result in the recognition of a qualifying quarter during Tax Year (TY) 2000. This was accomplished by performing a nationwide Master File analysis of all individual income tax returns processed for TY 2000 to identify all tax modules that contained an entry below \$119.34.
- II. Determined the total volume of taxpayers who had no Wage and Tax Statement (W-2) or no Social Security wages. This was accomplished by using the TY 2000 modules identified above, from which we selected a statistically valid sample with a 95 percent confidence level, an expected error rate of 15 percent, and a precision level of +/- 2 percent. From this sample, we identified and counted the number of modules without W-2 or Social Security income.
- III. Determined the total volume of taxpayers who had paid only the Medicare portion of the SE tax. This was accomplished by:
  - A. Identifying and counting, using the sample modules identified above, the number of modules with W-2 or Social Security income greater than \$76,200, which was the maximum amount of earnings subject to the Social Security tax for TY 2000.
  - B. Analyzing these modules to determine if the SE income was less than the \$780 minimum established by the Social Security Administration.

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<sup>1</sup> The Master File is the IRS' main computer system containing taxpayer accounts. The Individual Master File maintains transactions or records of individual tax accounts.

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**Appendix II**

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner N:DC  
Commissioner, Wage and Investment Division W  
Acting Deputy Commissioner, Small Business/Self-Employed Division S  
Director, Compliance, Small Business/Self-Employed Division S:C  
Director, Tax Forms and Publications, Wage and Investment Division W:CAR:MP:FP  
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division S:T  
Director, Taxpayer Burden Reduction, Small Business/Self-Employed Division S:T  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:AR:M  
Audit Liaisons:  
    Commissioner, Small Business/Self-Employed Division S  
    Commissioner, Wage and Investment Division W

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### **Appendix IV**

#### **Outcome Measures**

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

##### Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 319,051 taxpayer accounts affected (see page 2).

##### Methodology Used to Measure the Reported Benefit:

Self-employed taxpayers are required to pay self-employment (SE) tax when their net earnings from SE are at least \$400 for the tax year. However, Social Security Administration (SSA) regulations state that, in Tax Year (TY) 2000, a taxpayer did not earn any credit for wages or SE income of less than \$780. Our Master File<sup>1</sup> extract identified 1.1 million taxpayers who had submitted returns where they had computed and paid SE tax in an amount less than the amount that would be applicable for the required minimum (\$780 times 15.3 percent SE tax rate). We took a statistical sample of 1,460 of the tax returns involved (based on attribute sampling with a 95 percent confidence level and a precision level of +/- 2 percent) and found that 23 percent of these taxpayers derived no benefit from the payment of this tax. We also found that 5 percent of these taxpayers had paid only the Medicare portions of the SE tax on amounts less than \$780. We used the data from this sample to estimate the total number of taxpayers affected.

##### Type and Value of Outcome Measure:

- Taxpayer Burden - Potential; \$8.6 million per year. Over 5 years, \$43 million (see page 2).

##### Methodology Used to Measure the Reported Benefit:

From the statistical sample of 1,460 tax returns referred to above, we identified 340 taxpayers who: (1) submitted a Self-Employment Tax (Schedule SE) with their tax return, and (2) had either no Wage and Tax Statement (W-2) or no creditable SSA wages. We also identified 79 taxpayers who paid only the Medicare portion of the SE tax on earnings of less than \$780. These taxpayers spent time in fulfilling their SE tax obligations for which they received no SSA credit. TY 2000 Internal Revenue Service (IRS) instructions estimated that a taxpayer would spend 52 minutes, in total, on a Schedule SE using the short method and 99 minutes using the long method. We used the data from the sample to estimate the number of taxpayers affected and applied the IRS' time figure to estimate the total time (in hours) spent on the Schedule SE calculations.

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<sup>1</sup> The Master File is the IRS' main computer system containing taxpayer accounts.

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To calculate the dollar value of the taxpayers' time, we used the amount of \$26.50 per hour as established by the Office of Management and Budget (OMB) for the value of tax paperwork time.

### Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 242,905 taxpayer accounts affected (see page 6).

### Methodology Used to Measure the Reported Benefit:

Self-employed taxpayers are required to pay SE tax when their net earnings from SE are \$400 or greater. However, SSA regulations state that, in TY 2000, only the first \$76,200 of a taxpayer's combined wages, tips, and net earnings from self-employment was subject to the 12.4 percent Social Security tax. The 2.9 percent Medicare tax had no maximum wage limitation. The IRS requires taxpayers who are paying only the Medicare portion of the SE tax to use the long method when completing the form and computing the amount owed.

Our Master File extract identified 1.1 million taxpayers who had submitted returns where they had computed and paid SE tax in an amount less than the amount that would be applicable for the required minimum (\$780 times 15.3 percent SE tax rate). We took a statistical sample of 1,460 of the tax returns involved (based on attribute sampling with a 95 percent confidence level and a precision level of +/- 2 percent) and found that 22 percent of these taxpayers paid only the Medicare portion of the SE tax on SE income of at least \$780. We also found that 5 percent of these taxpayers had paid only the Medicare portions of the SE tax on amounts less than \$780. We used the data from this sample to estimate the total number of taxpayers affected.

### Type and Value of Outcome Measure:

- Taxpayer Burden - Potential; \$5 million per year. Over 5 years, \$25 million (see page 6).

### Methodology Used to Measure the Reported Benefit:

From the statistical sample of 1,460 tax returns referred to above, we identified 398 taxpayers who paid only the Medicare portions of the SE tax on SE income. We determined that 79 of the Medicare tax payments were made on SE income below the SSA minimum of \$780. TY 2000 IRS instructions estimated that a taxpayer would spend 52 minutes, in total, on a Schedule SE using the short method and 99 minutes using the long method. Taxpayers paying only the Medicare portions are required to use the long method. We used the data from the sample to estimate the number of taxpayers affected and applied the IRS time figure to estimate the total additional time (in hours) spent on the Long Schedule SE. This was done only for those taxpayers who had SE income of \$780 or greater.

To calculate the dollar value of the taxpayers' time, we used the amount of \$26.50 per hour as established by the OMB for the value of tax paperwork time.

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### **Appendix V**

### **Social Security and the Self-Employed Taxpayer**

#### **In General**

The Social Security program is based on the concept that when individuals work, they pay taxes into the program based on their earnings, and when they retire, become disabled, or die, they or their spouse and qualified dependents may receive monthly benefits that are based on those earnings. Taxes on wages are also known as Federal Income Contributions Act (FICA) taxes. Employers are required to withhold these taxes from employees' wages, remit the withholdings to the Internal Revenue Service (IRS) at least quarterly, and report each employee's earnings to the Social Security Administration (SSA) annually.

Since 1990, employers and their employees each were required to pay, as Social Security tax, 6.2 percent (12.4 percent total) of an employee's gross salary, up to a designated contribution base. In addition, a Medicare tax of 1.45 percent each (2.9 percent total) has been imposed since 1986, with no maximum earnings limitation since 1994.

Everyone born in 1929 or later needs 40 credits to be eligible for retirement benefits. During an individual's working years, wages are posted to their Social Security record, and they receive earnings credits based on those wages. For years before 1978, the SSA called credits "quarters of coverage" or QCs. An individual generally was credited with a quarter of coverage for each calendar quarter in which wages of \$50 or more were paid, or 4 quarters of coverage for every taxable year in which \$400 or more of self-employment (SE) income was earned. Beginning in 1978, employers have generally reported wages on an annual, instead of quarterly, basis. With this change to annual reporting, a quarter of coverage was credited for every \$250 of an individual's total annual wages and SE income, up to 4 quarters per year, no matter when the actual work was performed. The amount of earnings needed for a credit increases automatically each year as average earnings levels rise, and are based on a specific mathematical formula.

Although a person can earn their 4 credits with a small amount of earnings (i.e., for Tax Year (TY) 2000, it took only \$3,120 in total wages to earn the maximum), amounts earned over that total will enter into the computation of a person's benefit when they retire. The SSA uses a person's average earnings over their best 35 years of earnings to figure the benefit amount. The SSA sets a contribution and benefit base each year that is: (1) the maximum annual amount of earnings subject to Social Security tax, and (2) used in determining a person's benefit amount.

In TY 2000, only the first \$76,200 of a taxpayer's combined wages, tips, and net earnings from self-employment was subject to any combination of the 12.4 percent Social Security tax, Social Security part of the SE tax, or railroad retirement tax. There is no limitation or maximum on wages, tips, and net earnings that is subject to the Medicare part.

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The table below shows various rates and amounts for the past 7 years:

| Year | Benefit Base | FICA Tax Rate | Income Needed for One Credit | Income Needed for Four Credits |
|------|--------------|---------------|------------------------------|--------------------------------|
| 1996 | \$62,700     | 15.3 %        | \$640                        | \$2560                         |
| 1997 | \$65,400     | 15.3 %        | \$670                        | \$2680                         |
| 1998 | \$68,400     | 15.3 %        | \$700                        | \$2800                         |
| 1999 | \$72,600     | 15.3 %        | \$740                        | \$2960                         |
| 2000 | \$76,200     | 15.3 %        | \$780                        | \$3120                         |
| 2001 | \$80,400     | 15.3 %        | \$830                        | \$3320                         |
| 2002 | \$84,900     | 15.3 %        | \$870                        | \$3480                         |

### Self-Employed Taxpayers

Taxes on self-employment are sometimes referred to as Self-Employment Contributions Act (SECA) taxes and are mandated under Internal Revenue Code Section 1401.<sup>1</sup> Self-employed taxpayers report their earnings for Social Security when they file their federal income tax return. The SE tax rate is 15.3 percent (12.4 percent for Social Security and 2.9 percent for Medicare). Taxpayers figure the tax themselves using a Self-Employment Tax (Schedule SE). Self-employed taxpayers can deduct half of their SE tax from their adjusted gross income, while wage earners cannot deduct Social Security or Medicare taxes. Overall, the self-employed taxpayer will still pay a higher amount of tax (employment and income) than the wage earner. As an illustration, the chart below shows the various tax computations for a hypothetical employee and a self-employed taxpayer both earning \$1,000 in income.

|  | Employee | Self-employed Worker |
|--|----------|----------------------|
| Income   | \$1,000  | \$1,000              |
| Adjustment for one-half of the SE tax            | N/A      | \$71                 |
| Taxable Income                                   | \$1,000  | \$929                |
| Income Tax (at 15 percent rate)                  | \$150    | \$139                |
| SE tax (at 15.3 percent)                         | N/A      | \$141                |
| Social Security tax withholding (at 6.2 percent) | \$62     | N/A                  |
| Medicare tax withholding (at 1.45 percent)       | \$15     | N/A                  |
| Total taxes paid                                 | \$227    | \$280                |
| Available Income (Income less total taxes paid)  | \$773    | \$719                |

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<sup>1</sup> 26 U.S.C. § 1401 (1990).

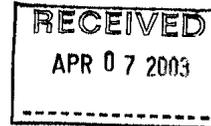
**Many Taxpayers Are Paying Self-Employment Tax for Which They Receive  
No Social Security Credit**

**Appendix VI**

**Management's Response to the Draft Report**



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224



APR - 7 2003

**MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT**

**FROM:** *for* Joseph G. Kehoe *[Signature]*  
Commissioner, Small Business/Self-Employed Division

**SUBJECT:** Draft Audit Report – Many Taxpayers Are Paying  
Self-Employment Tax for Which They Receive No Social  
Security Credit (Audit # 200130050)

We appreciate the opportunity to review and comment on the subject draft audit report. The National Taxpayer Advocate (NTA) has also reviewed your report and is responding under separate cover.

We agree with your overall findings that many taxpayers are paying self-employment tax for which they receive no Social Security credit. We will consult with the Social Security Administration, evaluate the issues and submit a proposal to the NTA for possible inclusion in its 2004 Annual Report to Congress. Tax Forms and Publications will revise instructions for long Schedule SE to address self-employed customers' needs.

As to issues regarding measurement, please note that the Service is working with IBM Consulting to develop a new, more accurate and flexible methodology for measuring burden on individual and self-employed taxpayers. The new methodology measures burden as time spent and out-of-pocket costs incurred by taxpayers. Taxpayers' time was not monetized because of the difficulty of justifying or obtaining consensus on any specific amount.

Our comments on your recommendations follow:

**RECOMMENDATION 1**

The Commissioner, Small Business/Self-Employed (SB/SE) Division, whose operating division serves self-employed taxpayers, should coordinate with Chief Counsel; the Director, Legislative Affairs; the National Taxpayer Advocate; and the SSA, to evaluate the tax law and design a possible legislative solution to address the inequity and reduce the excess taxpayer burden.

## Many Taxpayers Are Paying Self-Employment Tax for Which They Receive No Social Security Credit

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### **CORRECTIVE ACTION**

We agree with TIGTA's recommendation that a change to the tax law will address the statutory inequity discussed in its audit report.

This issue was previously evaluated, and the National Taxpayer Advocate (NTA) 2000 Annual Report to Congress promoted a legislative solution to increase the net self-employment income threshold amount and to provide for future indexing. House bill HR 1037 proposed changes to Section 1402(b) and Section 6017 of the Internal Revenue Code. Although this bill was introduced in the First Session of the 107<sup>th</sup> Congress, it was not enacted.

Resolving this inequity will require legislative changes to the Social Security Administration Code and to the Internal Revenue Code. If the Social Security Administration will support co-sponsored statutory resolution, we will re-evaluate the issue using current data and submit a proposal to the NTA for possible inclusion in its 2004 Annual Report to Congress.

### **IMPLEMENTATION DATE**

September 30, 2003

### **RESPONSIBLE OFFICIALS**

Director, Taxpayer Education and Communication Office of Taxpayer Burden Reduction, Small Business/Self-Employed Division

### **MONETARY BENEFIT**

We cannot measure the monetary benefits cited in the report.

### **CORRECTIVE ACTION MONITORING PLAN**

The Director, Taxpayer Education and Communication, Small Business/Self-Employed Division will monitor the corrective action.

### **RECOMMENDATION 2**

The SB/SE Division's Director, Taxpayer Education and Communication, and Director, Tax Burden Reduction, should coordinate with the Wage and Investment Division Director, Tax Forms and Publications, to evaluate the design and clarity of the Schedule SE, and its instructions in order to alleviate the additional taxpayer burden.

## Many Taxpayers Are Paying Self-Employment Tax for Which They Receive No Social Security Credit

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### **CORRECTIVE ACTION**

Tax Forms and Publications has already evaluated Schedule SE. They will soon circulate revised instructions, which will reduce reporting burden by allowing certain taxpayers to "skip" lines on the long Schedule SE. We considered allowing more taxpayers to use the short Schedule SE. However, this alternative would add reporting burden for short Schedule SE users. SB/SE and other stakeholders will participate in the preliminary review process for the revised instructions, assessing whether the proposed revision meets customers' needs.

### **IMPLEMENTATION DATE**

October 31, 2003

### **RESPONSIBLE OFFICIAL**

Director, Tax Forms and Publications, Wage and Investment Division

### **MONETARY BENEFIT**

We cannot measure the monetary benefits cited in the report.

### **CORRECTIVE ACTION MONITORING PLAN**

The Director, Tax Forms and Publications, Wage and Investment Division will monitor the corrective action.

If you have any questions please contact me at (202) 622-0600, or Bobby Hunt, Director, Office of Taxpayer Education and Communication, Small Business/Self-Employed Division at (202) 283-2627.

**Many Taxpayers Are Paying Self-Employment Tax for Which They Receive  
No Social Security Credit**

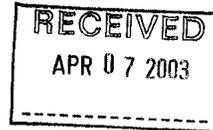
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Appendix VII

**National Taxpayer Advocate's Comments on the Draft Report**



National Taxpayer Advocate



APR 4 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM: Nina E. Olson *Nina E. Olson*  
National Taxpayer Advocate

SUBJECT: Response to Draft Audit Report – Many Taxpayers Are Paying  
Self-Employment Tax for Which They Receive No Social  
Security Credit (Audit # 200130050)

I have reviewed the subject draft audit involving the issue of taxpayers' paying self-employment tax for which they receive no Social Security credit. Because the draft report makes reference to the National Taxpayer Advocate's Fiscal Year 2000 Annual Report to Congress and because your first recommendation makes reference to the National Taxpayer Advocate, we wish to offer certain comments.

As the draft report notes, the Internal Revenue Code requires self-employed persons to pay Social Security taxes if their net earnings are \$400 or more. See IRC §§ 6017 and 1402. This \$400 threshold is not indexed. By contrast, the Social Security laws grant credits for quarters of coverage ("credits") to self-employed persons only if their net earnings exceed an indexed amount that is \$890 in 2003. See 42 U.S.C. § 413(d) (setting amount at \$250 for 1978 and providing a formula for indexing); 67 Fed. Reg. 65,620 (Oct. 25, 2002) (setting amount at \$890 for 2003 pursuant to statutory formula). As a result of these different thresholds and the indexing of only the higher threshold a significant and growing number of self-employed persons are paying Social Security taxes yet are not receiving credits.

The National Taxpayer Advocate's Fiscal Year 2000 Annual Report to Congress, which was issued before I joined the IRS, recommended that legislation be enacted to eliminate this gap. The Small Business/Self-Employed Operating Division recommended the proposal in 2001, and it was included in legislation introduced in the Congress in 2001. See H.R. 1037, 107<sup>th</sup> Cong. § 304 (2001). I concur that serious attention should be given to this issue. If a self-employed person is required to pay into the Social Security system, the person has a reasonable expectation that he or she will receive credits. The contrary result seems unfair and has the potential to undermine taxpayer confidence in the fairness of the tax system.

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**The Office of the Taxpayer Advocate operates independently of any other IRS Office and reports directly to Congress through the National Taxpayer Advocate.**

## Many Taxpayers Are Paying Self-Employment Tax for Which They Receive No Social Security Credit

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Having said that, the proposal raises certain questions of equity regarding how self-employed persons (who are subject to the Self Employment Contributions Act, or "SECA") are treated in comparison with wage earners (who are subject to the Federal Insurance Contributions Act, or "FICA"). Under current law, wage earners are subject to FICA taxes from their first dollar of earnings. While self-employed persons pay tax but receive no credits if their incomes fall between \$400 and \$890, wage earners generally pay tax but receive no credits if their incomes fall between \$1 and \$890. Compare IRC §§ 3101 and 3121 (providing rules for wage earners) with IRC §§ 1402 and 6017 (providing rules for self-employed persons). So the range of earnings that falls into this "gap" is already greater under current law for wage earners than for self-employed persons, yet the proposal at issue would not provide any relief for wage earners. Indeed, if Congress were to adopt the proposal to raise the taxing threshold for self-employed persons from \$400 to the Social Security credit threshold (currently \$890), the disparity between the treatment of self-employed persons and the treatment of wage earners would widen.

This disparity may well be justified based on the significant differences between the structures of the FICA and SECA tax regimes. For example, FICA is essentially a gross-basis tax while SECA is a net-basis tax (*i.e.*, it is imposed on gross income from a trade or business less deductions attributable to the trade or business). Also, a self-employed person is liable for twice the amount of employment tax as a wage earner (although the self-employed person is entitled to deduct a portion of the payment). For these reasons, it may be reasonable to conclude that comparisons between self-employed persons and wage earners are not significant for purposes of the proposed recommendation. Alternatively, it may be reasonable to recommend a similar change in the laws applicable to wage earners, although such a change may complicate matters for employers subject to withholding rules and would cause a more significant revenue loss. The draft audit report alludes to this SECA/FICA equity issue in the final chart in Appendix V, but it does not discuss the issue in any detail.

Regarding your specific recommendation that the Commissioner of the Small Business/Self-Employed Operating Division (SB/SE) coordinate with other divisions of the IRS and the Social Security Administration to design a possible legislative solution, I concur that SB/SE should conduct an examination of the issue and should determine whether a legislative change is appropriate. If SB/SE conducts this examination, it should coordinate with the Office of the Taxpayer Advocate and should explore more fully the SECA/FICA equity issue discussed above.

Thank you for the opportunity to review and comment on this report. If you have any questions or concerns, please call Rena Girinakis at (202) 622-4321.